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Iowa Lottery Report On Operations, Summer 2005

To: Members of the House Government Oversight Committee and Senate Government Oversight Committee

From: Dr. Ed Stanek, President and CEO

Date: August 2005

The Iowa Lottery Authority achieved record sales in its latest fiscal year and raised nearly \$51 million for state programs.

Preliminary figures show that lottery sales totaled \$210.7 million in fiscal year 2005, which ended June 30. That was up about 1 percent from FY 2004 sales of \$208.5 million and marked the highest sales total for the lottery in its 20-year history.

The unaudited figures show the lottery raised \$50.9 million in revenues for state programs during FY 2005, a decrease of about 8 percent from the previous year. Two main factors affected the lottery's 2005 profits: the cost of equipping Casey's General Stores locations in Iowa to sell lottery products; and a decrease in Powerball® sales.

The lottery was pleased to welcome Casey's 350 Iowa convenience stores to its retailer base in fiscal year 2005, but the addition meant an expenditure of about \$2 million by the lottery for satellite communications equipment, ticket-dispensing equipment and point-of-sale material for those locations. All of that cost fell into one fiscal year, but the long-term benefits to the state will more than offset that.

The lottery began installing equipment in Casey's stores in mid-September 2004 and completed installations in late January 2005.

Iowa Powerball sales in FY 2005 were down more than 17 percent compared to the previous year. And, although sales of other lottery products more than made up the difference, those other products had a lower profit margin. Changes announced in Powerball that will take effect in August are projected to positively impact the game.

FY 2005 also saw the Iowa Lottery become the first in the world to begin selling an electronic version of the instant-scratch game. The new product, known as the electronic game card, is battery powered and loaded with dozens of plays on each card. The first

game card, called “Quarter Play,” sold strongly in a market test that began in October 2004, and the lottery went forward with statewide sales in May 2005.

Sales of instant-scratch tickets, the lottery’s traditional sales leader, again led the way in FY 2005, with sales in the category increasing by more than 8 percent to \$103.3 million. Sales in Hot Lotto made the biggest increase among the lottery’s traditional products, jumping nearly 23 percent to more than \$2 million. Hot Lotto is a multi-state game that is played like Powerball, but with easier odds and jackpots starting at \$1 million.

Throughout FY ‘05, the lottery also continued its partnership with small businesses around the state in the deployment of monitor vending machines, which add video and sound to the process of dispensing a ticket. Net sales from the machines, which are marketed under the brand name TouchPlay, totaled about \$6.4 million for the year.

Turning 20



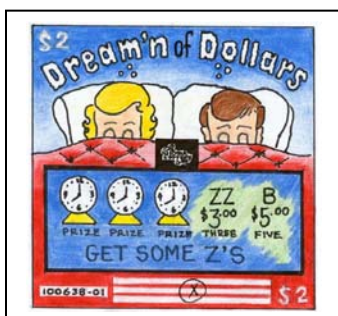
Has it been that long? A billboard in front of the lottery’s longtime headquarters building in Des Moines announced the start of ticket sales in 1985. A lottery employee modeled one of the “money bags” costumes used in the sales kick-off.

The Iowa Lottery is marking its 20th birthday with games and promotions designed to thank players for two decades of support. Legislation creating the Iowa Lottery was signed into law on April 18, 1985, and lottery sales in Iowa began on Aug. 22, 1985.

Some “landmark” figures for Iowa’s lottery through the end of FY 2005:

- Lottery sales in the state have totaled nearly \$3.5 billion.
- The lottery has raised nearly \$935 million for state programs.
- Iowa Lottery players have won nearly \$1.9 billion in prizes.
- Lottery tickets are sold at more than 3,800 retail locations in Iowa.

The lottery’s 20th birthday initiatives include:



- A “design-a-game” contest. Some of the most inventive ideas for lottery games have come from players themselves and the lottery’s latest contest reinforced that concept. Alice Hayes of Webster City won the contest’s top prize of \$3,000 with a ticket design she entitled “Dream’n of Dollars.” The ticket art she drew showed a couple tucked in bed with just the tops of their heads peeking out from under the covers. Above them are scenes from their happy dreams of big winnings. Hayes’ entry was among more than 1,900 that the Iowa Lottery received in its “Design A Game From Scratch” contest from



May 2-27. Iowans were invited to submit their original ideas for instant-scratch games for the chance to win cash prizes. The lottery has held a few design-a-game contests during its 20-year history and several contestants' ideas have gone on to become popular games.

□ The "Thanks A Million" instant-scratch game and promotion. Sales of the \$10 instant-scratch game began July 18 and drawings in the promotion continue through late January. Players who don't win a cash prize on their ticket can mail it in for drawings that are held every two weeks. The first drawing on Aug. 4 was for \$500 and prize amounts in the drawings go up to \$1 million, which will be given away Jan. 26.

Powerball Changes – And What About Those Fortune Cookies?

Earlier in this report, we referenced changes upcoming in the Powerball game. The changes are designed to meet player expectations for larger, faster growing jackpots and accommodate population changes in the Powerball group. Powerball sales began in April 1992, with 15 states, including Iowa, participating in the game. Today, Powerball is sold by 29 lotteries, including three that joined the game in 2004 and pushed its combined population to about 92 million.

Beginning Aug. 28, the guaranteed starting jackpot in Powerball will increase from \$10 million to \$15 million. Another change will double the prize for those players who match the first five numbers but miss the Powerball. They'll win \$200,000 instead of the current \$100,000. Two white balls will be added to the first pool of numbers in Powerball drawings, meaning players will choose five numbers from 55. Players will continue to select the Powerball from a pool of 42.

Powerball's annuity option will be changed so that players receive an annual payment that increases each year (the jackpot currently is paid out in 30 equal installments over 29 years). Players also can continue to choose to receive the jackpot as a lump-sum cash payment, but the option to receive ever-growing payments is in response to players who have voiced concerns about the effects of inflation on their annuity.

Powerball plays will still cost \$1 and drawings will continue to be held at 9:59 p.m. on Wednesdays and Saturdays. The overall chance of winning a prize in Powerball will change only slightly, from about 1 in 36 to 1 in 36.6. The odds of winning the jackpot will change from about 1:120.5 million to 1:146.1 million.

Fortune Cookies

Two recent Powerball drawings highlighted the unusual events that can occur in the world of random statistics. In the March 30 drawing, a Powerball player in Tennessee won the \$25.5 million jackpot, but the unusual part of the story came at the game's second-prize level: Lottery officials had expected just four or five players to match the first five numbers to win either \$100,000 or \$500,000. The results that night, however, revealed that 110 players around the country won the "Match 5" prize. All of those players, including three

who bought their tickets in Iowa, chose their Powerball numbers from the “lucky numbers” they had gotten in fortune cookies.

The fortune cookies were produced by Wonton Food Inc. of Long Island City, N.Y., which makes about 4 million cookies each day. The company started printing lottery numbers for entertainment on fortunes 10 years ago, with employees choosing numbers from those mixed in a big bowl. The lucky numbers on the Powerball players’ fortunes came close to winning it all, with the numbers 22-28-32-33-39 being drawn as the first five numbers that night. Only the sixth number on the fortunes was wrong: The Powerball on March 30 was 42; the fortunes picked it as 40.

Eighty-nine Powerball tickets won a \$100,000 prize in that drawing by matching the first five numbers. Three of the \$100,000 winners were Iowa Lottery players. Another 21 tickets won a \$500,000 prize each by matching the first five numbers and the Power Play® number. Players purchase the Power Play option for another \$1 per play for a chance to increase prizes (except the jackpot) up to five times.

Security standards of the West Des Moines-based Multi-State Lottery Association, which administers the Powerball game, require an emergency reserve fund to handle such drawing anomalies that can – and do – happen despite extensive modeling to predict prize payouts based on sales in the game. Without the emergency fund, Powerball member lotteries would have faced an assessment to cover the \$19.4 million unanticipated payout on March 30.

On June 18, the fortune cookie phenomenon in Powerball happened again. Statistical modeling predicted five Match 5 winners in the drawing, but there were 86 (72 of \$100,000 and 14 of \$500,000). Many of the winners again stated that they had chosen their Powerball numbers from those they received in fortune cookies.

New Lottery Headquarters – And A Fire There



Iowa Lottery headquarters building at 2323 Grand Ave. in Des Moines.

On Aug. 4, the Iowa Lottery moved to its permanent headquarters building on Grand Avenue in Des Moines, culminating a purchase project that had started more than a year earlier.

In September 2004, the lottery notified members of the Oversight Committees about its plans to issue revenue bonds to pay for a headquarters location in Des Moines and vending machines for its instant-scratch and pull-tab tickets. Both purchases are designed to achieve long-term savings to the state.

The revenue bonds to pay for the projects were issued in October 2004. From November 2004 through April 2005, the lottery installed 1,020 new pull-tab vending machines and

300 new instant-scratch ticket vending machines in retail locations around the state.

On Dec. 30, 2004, the lottery closed on the purchase of its headquarters building at 2323 Grand Ave. in Des Moines. The building, across the street from Iowa's governor's mansion, had been home to Farmers Mutual Hail Insurance Co., which built a new headquarters location in West Des Moines.

The 2003 legislation that created the Iowa Lottery Authority included language authorizing the Authority to "enter into contracts to incur debt in its own name and enter into financing agreements with the state, agencies or instrumentalities of the state, or with any commercial bank or credit provider." Written notice to the Legislative Oversight Committee and approval from the Executive Council is required for the lottery to borrow more than \$1 million.

In investigating options available to the lottery, lottery executives found that the Authority could obtain federally tax-exempt financing as an instrumentality of the state. With the assistance of the State Treasurer's office, lottery executives prepared the necessary paperwork and received approval from the state Executive Council to borrow up to \$10 million to buy the headquarters building and vending machines.

The Lottery purchased the vending machines from Pollard Banknote, based in Winnipeg, Canada. The machines were manufactured in Council Bluffs by Pollard's subsidiary, American Games Inc., which also provides maintenance for them. Financial projections show that by purchasing the machines instead of using traditional six-year leasing arrangements, the lottery should save about \$1.7 million in that time. The lottery could extend the machines' use even beyond that, resulting in further savings to the state.

Purchasing the building at 2323 Grand Ave. also is projected to produce savings for the Lottery. Rent on the Lottery's past headquarters at 2015 Grand Ave. totaled \$348,000 per year, with no accumulation of equity. The lottery's annual payment on the bonds issued to buy 2323 Grand Ave. will total \$200,345 and the lottery will build up equity during the 15-year amortization period for the bonds.

Fire At Headquarters

An electrical fire Aug. 23 shut down the lottery's new headquarters for about 24 hours. No one was injured in the incident, but employees had to evacuate the building for the day. Lottery sales and drawings were not affected by the fire.

Lottery workers in the basement of the building reported hearing several loud pops about 8:50 a.m. Aug. 23 and saw white flashes of light from an equipment room. Smoke then began filling the building. Investigators indicated that the fire was started by electrical equipment.

Repair crews restored electrical service to the lottery building the next morning, allowing employees to return to the workplace. Clean-up crews that specialize in fire-damage cleaning also were called in.

During the period that the lottery's headquarters was closed, players could purchase tickets and claim prizes at retail outlets, however, they could not validate tickets or claim prizes at any Iowa Lottery office. Those functions resumed Aug. 24.

Under Iowa law, funds of the state cannot be spent to pay lottery expenses so the Iowa Lottery, unlike state agencies, has insurance. The Lottery is working with its insurance company to determine total damage and losses from the fire.

Monitor Vending Machines
(marketed under the brand name TouchPlay)



As we noted earlier in this report, the lottery has continued its partnership with small businesses around the state in the deployment of monitor vending machines, which add video and sound to the process of dispensing a ticket. Net sales from the machines, which are marketed under the brand name TouchPlay, totaled about \$6.4 million for FY 2005. Eighty-three small businesses have passed financial and criminal history background checks to be licensed by the lottery as retailer-operators that can place TouchPlay machines in the state, and four companies have been certified by the lottery to manufacture TouchPlay machines. Those private companies have invested at least \$45 million to date in manufacturing, purchasing and installing TouchPlay machines.

In late May, the Iowa Lottery imposed a moratorium on new applications for manufacturer certifications and retailer-operator licenses. Lottery executives monitoring the development of the TouchPlay project determined that numbers on both the manufacturer and retailer-operator front were sufficient to serve the public convenience. While the lottery will continue to monitor the situation, both moratoriums will continue indefinitely.

Lottery personnel are inspecting each business where TouchPlay machines are being installed and operated to ensure compliance with state rules and regulations regarding the sale of lottery tickets. All TouchPlay premises locations are inspected before equipment is installed and lottery personnel will continue the inspections on a recurring basis.

The lottery also is requiring that the retailer-operators installing TouchPlay machines around the state undergo training regarding the rules and regulations involved in the machines' operation. In mid-July, the lottery led five training sessions around the state that were attended by TouchPlay retailer-operators and dozens of their employees. Retailer-operators will not be able to install machines until they have completed the lottery's TouchPlay training session and the lottery will continue to conduct the training on an annual basis.

Statewide deployment of TouchPlay machines began in April 2004. All parties involved in the TouchPlay project receive a share of the net revenue from machines (net = sales –

prizes). The Lottery's share of the net is the same from retailer to retailer and is established on a calendar-year basis. For the current calendar year, the Lottery receives 24 percent of the net revenue from TouchPlay and that figure will increase to 34 percent by calendar year 2009. The rest of the net revenue from each machine is split by the machine manufacturer, the retailer who purchases the machine and the business location where the machine is installed. The Lottery does not establish payment levels for those three parties, and instead, leaves that determination open to negotiation among them.

The price of TouchPlay tickets varies from game to game, just as prices vary for the Lottery's other products (instant-scratch games, pull-tab games and lotto games). For example, tickets in some pull-tab games cost \$1 each while tickets in other games may cost 25 cents or 50 cents each. The price of the game is the same from retailer to retailer, but different games have different price points. The same is true for the Lottery's instant-scratch, lotto and TouchPlay games. All TouchPlay retailers charge the same price per ticket in a particular game, but different games have different price points.

Here is a day-to-day working picture of how the Lottery accounts for revenues in the TouchPlay program: All Lottery TouchPlay machines report via telephone line to a central system so that money going into the machines and prizes being paid from TouchPlay tickets can clearly be tracked. Information about sales and prizes is collected at each machine manufacturer's central system and then compiled in the Lottery's accounting system, where an invoice is prepared for each retailer. That invoice details TouchPlay sales by location and breaks out the Lottery's share of net revenue from each machine as well as the manufacturer's share of the net. Through electronic funds transfer, the Lottery collects money each week from retailers' bank accounts. The Lottery collects both its share of the net and the manufacturer's share of the net, then forwards the manufacturer's share to that particular company. TouchPlay revenues become part of the total Lottery transfer made each quarter to the state.

The TouchPlay project has addressed several key areas of concern with state leaders:

1. The machines do not pay out cash. Players receive tickets that can be redeemed for Lottery prizes at the businesses where they play or at Lottery regional offices.
2. The machines do not utilize an internal randomizer when producing a play. All plays come from a predetermined pool of plays, just like the Lottery's instant-scratch games and pull-tab games.
3. Like all other Lottery products, the machines must be located in age-controlled environments (premises where the age of patrons is monitored by the employees of the establishment). And, players must be 21 to use TouchPlay machines.

Businesses that offer an age-controlled environment may have two TouchPlay machines, with four machines allowed in fraternal organizations or those businesses that provide an age-restricted environment, meaning an area where those under 21 years of age cannot enter. The Lottery has included the per-location machine limits in its business plan for the TouchPlay project, but is currently drafting changes to its administrative rules to include the per-location restrictions. That proposed rules change will soon be filed with the Administrative Rules Review Committee.



Electronic Game Card Update

In May, the Iowa Lottery began statewide sales of the world's first electronic version of the instant-scratch game. The lottery was the first to bring the new product, known as the electronic game card, to market. The first game card is "Quarter Play," which aptly describes it – with 80 plays on a card sold for \$20, each play costs 25 cents.

Players and retailers greeted the new product enthusiastically and sales have remained strong. The lottery has scheduled two more game cards for release in late 2005 and early 2006.

Each game card, about the size of a driver's license, is battery powered and loaded with dozens of random plays. Players activate the cards by pulling off a plastic tab on the back. Pushing a "play" button on the front of each card activates one of the plays on the card – essentially the same as an individual scratch ticket. But in the case of the game card, an electronic play replaces the traditional scratch play of a paper ticket. Three small screens on the front of the card display the numbers in a particular play and show whether it has won a prize. Players accumulate points, each having a value of 25 cents, by matching three like numbers as they advance through the 80 plays.

At the conclusion of all the plays, the game card displays the total points accumulated. Players redeem the cards as they do any other lottery product – by having their ticket validated at an Iowa Lottery retailer or one of the lottery's regional offices.

Lotto Game Patent

In May, the U.S. Patent Office issued a new patent to Ed Stanek in conjunction with the Iowa Lottery and the Multi-State Lottery Association for a new lotto game design. Stanek is noted as the inventor of the game, but any royalties or other financial benefits derived from it would become the property of the Iowa Lottery and MUSL.

The new game design involves the concept of a "super pool" of money that could be split among more than one prize level. The game could be played by lottery players in different countries who use different currencies and could be playing for a top prize that varies from country to country.

The game would work this way: When ticket sales closed for a particular drawing, all lotteries would report their sales to a central entity and the different currencies involved would be converted into one reference currency. After the drawing, each lottery in the game would be notified if there had been a jackpot winner (called the Super Pool winner). If there was no jackpot winner, the amount of money in the Super Pool would increase, but each lottery in the game would be able to set a jackpot "ceiling," or maximum amount, for its players.

There could be more than one jackpot winner in the game, as there can be in Powerball today. The jurisdictions without a jackpot winner would pay prizes at each prize level as normal. However, a different approach would be used by the lotteries with a jackpot winner. In those areas, each jackpot winner would be paid in local currency up to the amount of the jackpot “ceiling” established in that jurisdiction. Any money above that amount would “spill down” to lower prize levels in the game, creating the possibility of many large-prize winners.

The game design would create a new lottery dynamic. In today’s lotto games, players buy tickets in hope of winning the jackpot and if they aren’t the jackpot winner, they don’t really care who is. But in the newly patented game, players who don’t win the jackpot still would be rooting for a jackpot winner from their jurisdiction so they could share in the larger prizes created by the “spill down” effect.

Currency fluctuations between countries would be addressed in the game in a number of ways, including a requirement that each lottery deposit in the Super Pool a uniform amount in a single currency for each chance sold.

Promoting Iowa

Fiscal Year 2005 found the Lottery continuing the important work of highlighting the state’s success stories. Examples of projects include:



Reelin’ In The Cash. On April 18, the Iowa Lottery released a \$1 fishing-themed instant-scratch game called “Reelin’ in the Cash.” Players who didn’t win a cash prize could use their non-winning tickets to buy a fishing license at a discounted price through the Iowa Department of Natural Resources (DNR) Web site.

During the “Reelin’ in the Cash” promotion period from April 20-May 31, the number of annual fishing licenses sold through the DNR Web site increased more than five fold. And, after just seven weeks of sales, the scratch game was nearly sold out at lottery retail locations, translating into success for both state partners.

The focus on fishing began in August 2004, when statistics revealed a drop in Iowa fishing license sales and a resulting budget shortfall at the DNR. Sales of resident fishing licenses had fallen nearly 9 percent since 2000, resulting in a budget cut to the DNR’s fisheries, wildlife and conservation law enforcement bureaus in fiscal year 2004. Staffers at the Iowa Lottery, which has supported other state agencies through past games and promotions,

began brainstorming with the DNR about ways the two could work together to remind people about fishing opportunities in the state.

Reelin' in the Cash tickets went on sale April 18, featuring playful artwork of a fisherman who had caught a brightly colored fish with a mouthful of cash. Lottery players tried to find three like amounts or a fish symbol to win prizes of up to \$900. A printed message near the play area on each ticket reminded lottery players: "Buy your fishing license online now at www.iowadnr.com!"

That message was backed up with a value-added promotion through the DNR's Web site. Players with nonwinning tickets could visit the site and use the serial number on the back of their ticket to buy a 2005 annual Iowa fishing license at a special discounted price.

The promotion ran from April 20-May 31, providing a \$3.49 discount on each license purchased. The discount was sponsored by the Iowa Lottery and through the waiving of an online convenience fee of \$2.49 by Central Bank, which processes the license fees for the DNR. During the promotion period, the DNR sold 1,626 annual resident and nonresident fishing licenses through its Web site. That compares to just 284 during the same period of 2004.

On-Going Issues

WTO Decision: Iowa Lottery executives continue to closely monitor a decision by the World Trade Organization (WTO) that could affect all gambling in the United States. A WTO arbiter on Aug. 19 gave the United States until April 3, 2006, to comply with a decision that a U.S. ban on Internet gambling from the small Caribbean nation of Antigua & Barbuda violates WTO rules.

At issue is a complaint filed by Antigua & Barbuda over U.S. restrictions on Internet gambling. The small island nation has invested heavily in the electronic gambling industry to improve its economy and job opportunities, but the U.S. ban has kept American banks and major Internet search engines from doing business with gambling interests there.

Antigua & Barbuda had based its arguments on the General Agreement on Trade in Services (GATS) that was signed in 1994. A WTO dispute panel and appeals body both have found for the island nation. Under GATS, the United States agreed that it would not enact any laws or take any action that would be counter to open trade among nations signing the agreement. The United States agreed that entertainment and recreational services would be covered in GATS, but later argued that it did not mean for gambling to be included in that category.

Antigua & Barbuda argued that because the United States allows casinos, lotteries and other forms of betting, it has no basis to claim that gambling shouldn't be included in GATS.

The U.S. Trade Representatives Office has said it will do its best to meet the WTO's deadline for complying with the rulings in favor of Antigua & Barbuda. However, the trade representatives office also does not plan to ask Congress to weaken U.S. restrictions on Internet gambling.

Does the WTO decision mean that foreign interests should have the right to set up intrastate lotteries in the United States and offer casinos services on Indian reservations? Will more Internet gambling be allowed in this country? Time will tell.

Fuel Prices: Iowa Lottery executives continue to closely monitor fuel prices to determine their effects on sales and profits.

Gasoline prices in Iowa have spiked into record territory. According to the latest fuel price survey from the Department of Natural Resources, on Aug. 15, the average price for a gallon of self-serve, regular gasoline blended with ethanol in Iowa was \$2.45 per gallon – 28 cents higher than a month earlier and nearly 40 percent higher than at the same time a year earlier. Home heating costs also are predicted to be 15 to 20 percent higher this coming winter than last year.

With fuel prices cutting into consumers' discretionary income, sales of lottery products and other convenience items likely will be impacted. And the lottery, like other businesses, will face higher delivery costs and see other budget impacts from the higher fuel costs. But while some businesses can adjust the price of their products to pass along higher costs to consumers, that is not a possibility for lotteries, which sell products for firmly established prices such as 25 cents or \$1. An increase in the price of a lottery ticket from \$1 to \$1.05 would be shunned by consumers and have an extremely detrimental effect on sales.

Gambling Decisions: With the Racing and Gaming Commission's decision in May to allow four new casinos in Iowa, more competition will be created for consumers' discretionary income, meaning more competition for the Iowa Lottery and other businesses in the entertainment industry. The lottery will continue to monitor the expansion of gambling in Iowa and what impact that expansion could have on lottery income to the state.

Viruses and Spam: The popularity of lottery games also makes lotteries highly visible to those who try to infect e-mail systems with viruses, overload them with spam, or gain unauthorized access. Protecting the Iowa Lottery's e-mail system against such attacks requires ongoing resources and attention.

In one 30-day period this spring, the Iowa Lottery intercepted 936 e-mail messages that were infected with viruses and another 250 messages from spam-related sources. The lottery's firewall systems also showed 7 attempts – all unsuccessful – to access the lottery's network from outside the firewall.

The West Des Moines-based Multi-State Lottery Association, which oversees the Powerball game, also routinely sees incoming virus and spam attempts. Powerball players can e-mail MUSL staffers through a link on www.powerball.com. In one recent month, the MUSL system recorded 572,826 spam attempts and 14,023 virus attempts.